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INVESTMENTS, INC.; RYDEX
DISTRIBUTORS, INC.; NICK BONOS;
MICHAEL P. BYRUM; RICHARD M.
GOLDMAN; and CARL G. VERBONCOEUR

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA
SAN JOSE DIVISION

JAMES RAFTON, TRUSTEE OF THE
JAMES AND CYNTHIA RAFTON
TRUST,

Plaintiff,

v.
RYDEX SERIES FUNDS; PADCO
ADVISORS INC. d/b/a RYDEX
INVESTMENTS, INC.; RYDEX
DISTRIBUTORS, INC.; RICHARD M.
GOLDMAN; CARL G.
VERBONCOEUR; JOHN O. DEMARET;
NICK BONOS; MICHAEL P. BYRUM;
COREY A. COLEHOUR; J. KENNETH
DALTON; WERNER E. KELLER;
THOMAS F. LYDON; PATRICK T.
MCCARVILLE; ROGER SOMERS; and
DOES 1 through 25, inclusive,
Defendants.

Case No. 10cv1171 LHK
Action filed: March 19, 2010

**THE RYDEX DEFENDANTS' REPLY
MEMORANDUM OF POINTS AND
AUTHORITIES IN SUPPORT OF
MOTION TO DISMISS PLAINTIFFS'
FIRST AMENDED CLASS ACTION
COMPLAINT**

Date: December 16, 2010
Time: 1:30 p.m.
Dept: Courtroom 4, 5th Floor
Judge: Hon. Lucy H. Koh

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PRELIMINARY STATEMENT

Plaintiffs’ Opposition to the Rydex Defendants’ Motion to Dismiss (the “Rydex MTD”) crystallizes the fatal flaw in Plaintiffs’ case: Plaintiffs cannot identify any alleged misrepresentation or omission that is not directly refuted by the Inverse Government Long Bond Strategy Fund’s (the “Fund”) registration statements taken as a whole. The securities laws, and fundamental notions of fairness and justice, prevent investors from pursuing Securities Act claims unless the “total mix” of information supplied to them is materially misleading. Plaintiffs’ allegations here fall so far short of this standard that their Opposition nowhere attempts to explain how an investor could have been misled by a fair reading of all of the actual Fund disclosures. Instead, Plaintiffs ignore most of the relevant disclosures in favor of selected snippets taken out of context and mischaracterized. As a matter of settled law, this approach is untenable and cannot state a claim.

13 Plaintiffs' Opposition also reflects significant tactical retreats in a transparent effort to
14 stave off dismissal. Specifically, Plaintiffs built their Complaint on allegations that the Fund's
15 public disclosures misled investors into believing that the Fund was a "simple directional
16 investment" whose returns would correlate with the inverse of the cumulative price movements of
17 the 30-Year U.S. Treasury Bond ("Long Bond") *over time*. But Plaintiffs do not point to any
18 Fund disclosure that actually describes the Fund this way, because there is none. Rather, as the
19 Rydex MTD demonstrates, the Fund's disclosures clearly and repeatedly explain that the Fund
20 seeks to match the inverse of the price movement of the Long Bond on a *daily basis*, not over
21 time; that the Fund's returns may diverge significantly *over time* from the Long Bond's
22 cumulative price movement; and that, *over time*, the Fund historically had in fact deviated
23 significantly from the inverse of the Long Bond's cumulative price movement.

24 Plaintiffs have thus abandoned their Complaint allegations in favor of two different
25 theories advanced for the first time in their Opposition. First, Plaintiffs rely on an “investor
26 profile” disclosure that says *nothing* about whether the Fund is a “short-term” or “long-term”
27 investment. Moreover, this single sentence in the prospectus is surrounded by disclosures that
28 emphasize (i) the “daily” nature of the Fund, (ii) that the Fund may not correlate with the Long

1 Bond's cumulative price movement over time, and (iii) the likely effect of compounding on the
 2 Fund's performance over time compared to the Long Bond's cumulative price movement. When
 3 properly read in context, this "investor profile" disclosure is therefore perfectly consistent with
 4 the Fund's clear and repeated disclosures that the Fund would be managed to ensure that its
 5 investments performed inversely to the Long Bond's daily price movement--and nothing more.

6 Second, Plaintiffs now argue that what they call the "structure" of the Fund, *i.e.*, the fees
 7 paid by Fund investors, implies that the Fund is "a long term investment vehicle". Opp at 1. But,
 8 even aside from the fact that Plaintiffs never pleaded this theory in their Complaint, it is based on
 9 a stark mischaracterization of how the Fund's fees actually work. As the Fund's disclosures
 10 made clear in long passages that Plaintiffs ignore, the overall structure of the fees charged is
 11 deliberately designed to accommodate, rather than punish, short-term trading. In the words of the
 12 prospectuses, the Fund is "designed and operated to accommodate frequent trading."

13 In the end, despite multiple attempts, Plaintiffs have failed to articulate any viable
 14 misrepresentation or omission claim under Sections 11 or 12(a)(2). They have failed because
 15 there is nothing misleading about the Fund's disclosures, which--when read objectively and in
 16 their entirety--fairly apprise investors of the daily objective of the Fund and the inherent
 17 implications of pursuing that objective, including the effects of "compounding" on Fund
 18 performance over time. Nothing Plaintiffs can do or say will change that fact or create a viable
 19 claim under the Securities Act. Accordingly, Plaintiffs' claims should be dismissed with
 20 prejudice.

21 ARGUMENT

22 I. PLAINTIFFS HAVE FAILED TO IDENTIFY ANY MISSTATEMENT OR 23 OMISSION

24 A. Plaintiffs Cannot Identify Any Prospectus Representation That States, Or 25 Even Hints, That The Fund's Performance Would Match The Inverse Of The Long Bond's Price Movements Over Time.

26 The crux of Plaintiffs' lawsuit, as set forth in their Complaint, is that the Fund's public
 27 disclosures allegedly misled investors into believing that the Fund's returns would correlate with
 28 the cumulative price movements of the Long Treasury Bond *over time*. See FAC ¶¶38, 41, 46-47.

1 This assertion is categorically false. As set forth in the Rydex MTD, Plaintiffs' core assertion
 2 cannot withstand even the slightest scrutiny in the light of the Fund's actual disclosures.
 3 Specifically, as the Fund disclosed in 2007, in 2008 and again in 2009:

- 4 • Rydex's benchmark funds, including the Fund, "seek to provide investment results
 5 that ***either*** match the performance of a specific benchmark on a daily basis ***or*** correlate
 6 to the performance of a specific benchmark over time." 2007 Prosp. at 65 (emphasis
 7 added); 2008 Prosp. at 79 (same); 2009 Prosp. at 79 (same).
- 8 • "Unlike a traditional index fund, the Fund's objective is to perform, ***on a daily basis***,
 9 exactly opposite its benchmark. . . ." 2007 Prosp. at 16 (emphasis added); *accord*
 10 2008 Prosp. at 28; 2009 Prosp. at 25.
- 11 • "The [Fund] seeks to provide total returns that inversely correlate to the price
 12 movements of a benchmark. . . . The Fund's current benchmark is the inverse of the
 13 ***daily price movement*** of the Long Treasury Bond." 2007 Prosp. at 16 (emphasis
 14 added); *accord* 2008 Prosp. at 28; 2009 Prosp. at 25.
- 15 • "If the Fund meets its objective, the value of the Fund's shares will increase on a ***daily***
 16 ***basis*** when the price of the Long Treasury Bond decreases." 2007 Prosp. at 16
 17 (emphasis added); 2008 Prosp. at 28 (same); 2009 Prosp. at 25 (same).
- 18 • "When the price of the Long Treasury Bond increases, however, the value of the
 19 Fund's shares should decrease on a ***daily basis*** by an inversely proportionate
 20 amount[.]" 2007 Prosp. at 16 (emphasis added); 2008 Prosp. at 28 (same); 2009
 21 Prosp. at 25 (same).
- 22 • "[I]f the price of the Long Treasury Bond increases by 2%, the value of the Fund's
 23 shares should go down by 2% ***on that day***." 2007 Prosp. at 16 (emphasis added);
 24 2008 Prosp. at 28 (same); 2009 Prosp. at 25 (same).
- 25 • The Fund faces "Tracking Error Risk," which means that, because the Fund "is
 26 tracking the performance of its benchmark on a ***daily basis***, mathematical
 27 compounding may prevent a Fund from correlating with the monthly, quarterly,
 28 annual or other period performance of its benchmark." 2007 Prosp. at 37 (emphasis
 29 added); 2008 Prosp. at 50 (same); 2009 Prosp. at 41 (same).
- 30 • "It is important to understand the effects of compounding when investing ***in any***
 31 ***mutual fund***[.]" 2007 Prosp. at 67 (emphasis added); 2008 Prosp. at 80 (same); 2009
 32 Prosp. at 80 (same).
- 33 • "[I]t is ***essential*** to understand the effect of mathematical compounding on [the
 34 Fund's] returns." 2007 AR at 3 (emphasis added); 2008 AR at 3 (same); 2009 AR at 4
 35 (same); 2007 SAR at 3 (same); 2008 SAR at 3 (same); 2009 SAR at 4 (same).
- 36 • "[P]eriods of high volatility in an underlying index will also cause the effects of
 37 compounding to be more pronounced[.]" 2007 AR at 3; 2008 AR at 3; 2009 AR at 4;
 38 2007 SAR at 3; 2008 SAR at 3; 2009 SAR at 4.
- 39 • "[O]ver time, the cumulative percentage increase or decrease in the net asset value of a
 40 fund ***may diverge significantly*** from the cumulative percentage increase or decrease in
 41 the multiple of the return of the index underlying a fund's benchmark ***due to the***
 42 ***compounding effect*** of losses and gains on the returns of the fund." 2007 Prosp. at 67

(emphasis added); 2008 Prosp. at 80 (same); 2009 Prosp. at 80 (same).¹ Moreover, the Fund also disclosed its historical returns in easy to understand charts, which demonstrate that the Fund’s cumulative returns over time did in fact “diverge significantly” from the inverse of the cumulative price movement of the Long Bond. *See* 2007 AR at 33; 2008 AR at 33; 2009 AR at 33; *see also* Rydex MTD at 7-8. These disclosures alone are dispositive of the very foundation of this lawsuit, and nowhere in their opposition do Plaintiffs even try to explain to the Court how their case can be reconciled with this “total mix” of investor information. *See, e.g., In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1408 (9th Cir. 1996).

Instead, Plaintiffs take misguided rifle shots at individual pieces of the disclosures; as explained below, none of these efforts is factually or legally well grounded and each can be readily dismissed:

12 First, Plaintiffs contend that the prospectuses' repeated references to the "daily" nature of
13 the Fund are irrelevant because investors would not understand that there is a distinction between
14 "daily" funds and funds that seek to correlate with a benchmark over time. *See* Opp. at 20-21.
15 But the prospectuses make this distinction crystal clear to investors by explaining that the Rydex
16 benchmark funds, including the Fund, "seek to provide investment results that ***either*** match the
17 performance of a specific benchmark on a daily basis ***or*** correlate to the performance of a specific
18 benchmark over time." 2007 Prosp. at 65 (emphasis added); 2008 Prosp. at 79 (same); 2009
19 Prosp. at 79 (same). Any reasonable investor would understand that the Fund has a daily goal and
20 therefore does *not* "seek to provide investment results that . . . correlate to the performance of a
21 specific benchmark over time". *Id.*

22 Second, Plaintiffs contend that the “tracking error” risk disclosure--which tells investors
23 directly that, because the Fund “is tracking the performance of its benchmark on a ***daily basis***,

²⁴ ²⁵ ²⁶ ²⁷ ²⁸ ¹ The Rydex Defendants apologize for the inadvertent omission of an ellipsis from this quote on page 21 of the Rydex MTD. Although Plaintiffs attempt to use this error to deflect attention from the deficiencies of their Complaint (*see Opp.* at 22-23), they fail to acknowledge that (i) the Rydex Defendants provided the relevant portions of each of the Fund’s prospectuses to the Court, (ii) on page 7 of the Rydex MTD, this entire disclosure is fully quoted, and (iii) on page 17 of the Rydex MTD, this disclosure is properly quoted with an ellipsis. In any event, as re-confirmed herein, this disclosure is undoubtedly one that the “sophisticated” Plaintiffs and the Fund’s other “reasonable investors” (*see FAC ¶¶37-38*) should have understood to pertain to this Fund.

1 mathematical compounding may prevent a Fund from correlating with the monthly, quarterly,
 2 annual or other period performance of its benchmark" (2007 Prosp. at 37 (emphasis added); 2008
 3 Prosp. at 50 (same); 2009 Prosp. at 41(same))--is inadequate because it states that compounding
 4 "may" prevent the Fund from correlating with its benchmark over time, rather than "shall" or
 5 "will" prevent correlation over time. *See* Opp. at 21. Plaintiffs' argument ignores the fact that
 6 both the FINRA Broker Notice and SEC Investor Notice use the very same conditional language.
 7 *See* Rydex MTD at 20; *see generally* Regulatory Notice 09-31, *Non-Traditional ETFs: FINRA*
 8 *Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-*
 9 *Traded Funds* (June 2009), Rydex MTD, Korol Decl., Ex. K; U.S. Securities and Exchange
 10 Commission, *Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-*
 11 *Hold Investors* (Aug. 18, 2009), Rydex MTD, Korol Decl., Ex. L. Plaintiffs do not and cannot
 12 explain how the prospectuses could have been misleading when they use precisely the same
 13 language that FINRA and the SEC used.² Moreover, courts routinely reject this type of semantic
 14 quibbling. Rydex MTD at 19-20 (citing cases); *see also Benzon v. Morgan Stanley Distrib., Inc.*,
 15 420 F.3d 598, 606, 608 (6th Cir. 2005).³

16 Third, Plaintiffs contend that the prospectus disclosure labeled "Understanding
 17 Compounding & The Effect Of Leverage" is inadequate because this disclosure purportedly
 18 "dealt solely with leverage." Opp. at 22.⁴ But the very first line of the disclosure explains to

19 ² By the same token, although Plaintiffs criticize the Fund's "Tracking Error" disclosure for
 20 failing to explain how large an effect compounding may have on a fund's performance over time
 21 (Opp. at 22), Plaintiffs fail to mention that neither the SEC Investor Notice nor the FINRA Broker
 22 Notice contains such an explanation.

23 ³ Plaintiffs do not even mention, much less attempt to distinguish, most of these cases, other than
 24 observing that a few of them involved Exchange Act claims. *See* Opp. at 21 n.7. This is a
 25 distinction without a difference, however, because it is well settled that the "threshold
 26 requirement [of a material misrepresentation or omission] is identical" for Exchange Act and
 27 Securities Act cases. *E.g., In re Lyondell Petrochemical Co. Sec. Litig.*, 984 F.2d 1050, 1052 (9th
 28 Cir. 1993). Furthermore, neither of the cases that Plaintiffs cite in support of their argument on
 this point--*Rombach v. Chang*, 355 F.3d 164 (2d Cir. 2004) and *In re Convergent Techs. Sec.*
Litig., 948 F.2d 507, 513 (9th Cir. 1991)--even addresses the question of whether a disclosure is
misleading because it uses the word "may" rather than the word "shall". Moreover, both
decisions hold that the statements at issue were *not* materially misleading. *See In re Convergent*,
948 F.2d at 517; *Rombach*, 355 F.3d at 175, 178.

29 ⁴ Plaintiffs also imply that this disclosure is somehow entitled to less consideration because it is
 30 contained in an omnibus prospectus and is "40 pages removed" from the discussion of the Fund's
 31 risks. Opp. at 5, 6 n.4. Plaintiffs' suggestion is a legal non-starter; as explained in the Rydex

1 investors that “[i]t is important to understand the effects of compounding when investing *in any*
 2 *mutual fund[.]*” 2007 Prosp. at 67 (emphasis added); 2008 Prosp. at 80 (same); 2009 Prosp. at
 3 80 (same). And the first example in this disclosure demonstrates how compounding affects a
 4 non-leveraged fund. 2007 Prosp. at 67; 2008 Prosp. at 80; 2009 Prosp. at 80. The truth is that
 5 compounding has some effect on the performance of all funds--leveraged or non-leveraged,
 6 inverse or non-inverse. For that very reason, and because Rydex offers and describes both its
 7 leveraged and non-leveraged inverse and non-inverse funds in combined prospectuses, those
 8 prospectuses warn that the “examples” used--including the example of a non-leveraged fund--
 9 “demonstrate that *over time*, the cumulative percentage increase or decrease in the net asset value
 10 of a Fund *may diverge significantly* from the cumulative percentage increase or decrease in the
 11 multiple of the return of the index underlying a fund’s benchmark *due to the compounding effect*
 12 of losses and gains on the returns of the fund.” 2007 Prosp. at 67 (emphasis added); 2008 Prosp.
 13 at 80 (same); 2009 Prosp. at 80 (same).⁵ Notably, the SEC Investor Notice undeniably applies to
 14 both leveraged and unleveraged inverse ETFs--Plaintiffs nowhere argue otherwise--yet it uses
 15 only an example of a leveraged ETF to illustrate the effects of compounding. Rydex MTD, Korol
 16 Decl., Ex. L at 2.

17 *Fourth*, while not disputing that the Fund’s historical return information demonstrates to
 18 investors that the Fund’s cumulative returns deviated from the Long Bond’s cumulative price
 19 movement over time, Plaintiffs ask the Court to ignore this information because it is contained in
 20 shareholder reports as opposed to the prospectus. *See* Opp. at 24. Yet Plaintiffs do not and
 21 cannot dispute that these reports were (i) incorporated by reference in the registration statements,
 22 (ii) sent to the Fund’s investors, and (iii) available on the SEC website. *See* Rydex MTD at 6, 21;
 23 Opp. at 24. Legally, there is *no* support for the proposition that these annual and semi-annual
 24 reports to shareholders are not part of the “total mix” of Fund information that courts must

25 MTD (and again ignored by Plaintiffs), Plaintiffs cannot ignore relevant parts of a prospectus
 26 because they allege that the prospectus is “long and tedious” or because they disagree with its
 27 “textual organization”. *See* Rydex MTD at 14 (citing cases).

28 ⁵ Plaintiffs’ Opposition also ignores the fact that a substantively similar disclosure, under the
 heading “A Brief Note On Compounding Of Returns,” was included on pages 3 or 4 of reports
 sent to shareholders six times during the putative class period. *See* Rydex MTD at 6, 21.

1 consider in assessing the sufficiency of a Section 11/12(a)(2) claim. *In re Stac Elecs. Sec. Litig.*,
 2 89 F.3d at 1408 (affirming the dismissal of Securities Act claims); *see also In re Alliance N. Am.*
 3 *Gov't Income Trust, Inc. Sec. Litig.*, 1996 WL 551732, at *5 (S.D.N.Y. Sept. 27, 1996) (relying
 4 on shareholder reports in addition to disclosures within prospectuses to dismiss Securities Act
 5 claims).⁶ Moreover, Plaintiffs own brief elsewhere relies on a disclosure (regarding the Fund's
 6 intended performance in a rising interest rate environment) set forth in these same shareholder
 7 reports. *See* Opp. at 2, 16.⁷

8 **B. Section 11 Does Not Require The Fund To Have Stated That “The Fund Was
 9 Suitable Only For Short-Term Investors Who Actively Manage Their
 Portfolios On A Daily Basis”**

10 Unable to proceed on their theory that the Fund was a “simple directional investment” that
 11 promised to correlate its returns with the inverse of the returns on the Long Treasury Bond over
 12 time, Plaintiffs' Opposition retreats to what is essentially a suitability theory. Plaintiffs now
 13 premise their lawsuit on the assertion that the Funds' prospectuses were misleading because they
 14 did not state expressly that “the Fund was suitable only for short-term investors who actively
 15 manage their portfolios on a daily basis”. Opp. at 17. This claim fails for several independently
 16 dispositive reasons.

17 **1. Alleged Omissions About The Suitability Of The Fund Are Not
 18 Actionable Under Section 11.**

19 Although Plaintiffs' Opposition is based on the notion that the Rydex Defendants were
 20 obligated to opine on the types of investors for whom the Fund is suitable, Plaintiffs completely

21 ⁶ Neither of the cases that Plaintiffs cite even remotely undermines the importance of an
 22 expressly-incorporated and shareholder-received annual report. *In re Apple Computer Sec. Litig.*,
 23 886 F.2d 1109 (9th Cir. 1989) concerned whether press statements could correct a corporate
 24 officer's allegedly misleading statement, and *Miller v. Thane Int'l, Inc.*, 519 F.3d 879, 887 (9th
 25 Cir. 2008) addressed whether shareholders were required to “seek out prior versions . . . or
 26 otherwise familiarize themselves with the ‘drafting history’ of a prospectus.”

27 ⁷ Plaintiffs also contend that it is “virtually a mathematical certainty” that the Fund “will lose
 28 money over the long term”. Opp. at 4. This is both untrue and irrelevant. First, as demonstrated
 in the Rydex MTD, compounding can either benefit or harm Fund performance over time,
 depending on the path and volatility of the daily price changes in the Long Treasury Bond.
 Second, the key point is that the Fund appropriately informed investors of the potential impact of
 compounding so that the investors could devise trading strategies that are appropriate for their
 own circumstances, as the Notices observed. Rydex MTD, Korol Decl., Ex. K at 4; *id.*, Ex. L at
 3.

1 ignore all of the authority set forth in the Rydex MTD (*see* pp. 23-24) explaining why there is no
 2 such legal duty. This unanimous authority, and Plaintiffs' silence in response, confirms that
 3 Plaintiffs cannot base their case on a purported duty to opine on the suitability of the Fund for
 4 investors.

5 **2. Plaintiffs' Proposed Additional Disclosure Is Not Needed To Clarify**
 6 **The Fund's Daily Goal Or The Impact Of Compounding.**

7 Recognizing that the law does not impose a duty on the Defendants to opine about
 8 suitability, Plaintiffs try to argue that the Fund created such a duty itself. But Plaintiffs' argument
 9 ignores the legal standard defining when existing disclosures can give rise to Section 11 liability
 10 for an alleged omission. Any such alleged omission, including the Rydex Defendants' decision
 11 not to opine about suitability in the manner suggested by Plaintiffs, is actionable *only* if the
 12 disclosures that are made "affirmatively create an impression of a state of affairs that differs in a
 13 material way from the one that actually exists." *Brody v. Transitional Hosp. Corp.*, 280 F.3d
 14 997, 1006 (9th Cir. 2002); *see* Rydex MTD at 23. "Consequently, it is not enough to allege that
 15 the statement is incomplete; rather, the plaintiff must state facts showing that, due to its
 16 incompleteness, the statement *affirmatively led the plaintiff in a wrong direction* (rather than
 17 merely omitted to discuss certain matters)". *In re Synchronoss Sec. Litig.*, 705 F. Supp. 2d 367,
 18 419-420 (D.N.J. 2010) (emphasis in original); *see also Kairalla v. Advanced Med. Optics, Inc.*,
 19 No. 07-05569, 2008 WL 2879087, at *4 (C.D. Cal. June 6, 2008) (holding that the failure to
 20 disclose an association between a contact lens solution and a type of eye infection was not
 21 actionable because the allegedly misleading statements "create no affirmative impression, either
 22 way, regarding the association").

23 In short, to state a Section 11 claim based on this alleged omission, Plaintiffs must show
 24 that the Fund's disclosures "affirmatively created" the impression that the Fund *was* appropriate
 25 for long-term investors who do not actively manage their portfolios. Plaintiffs neither address nor
 26 meet this standard.

27
 28

a. The Prospectuses Never Describe The Fund As “Appropriate” For “Long-Term Investors”

Plaintiffs repeatedly assert that Defendants “describe[d]” the Fund as “a long-term investment vehicle” or as an investment that was “appropriate” for “long-term investors.” Opp. at 1, 15; *see generally id.* at 16-18. These repeated assertions are false; no disclosure actually describes the Fund this way. So instead, Plaintiffs rely heavily on the “investor profile” disclosure, which states that the Fund may be appropriate for “[i]nvestors who expect the value of the Long Treasury Bond to go down and want investment gains when it does so.” 2007 Prosp. at 16; 2008 Prosp. at 28; 2009 Prosp. at 25. Specifically, Plaintiffs assert that this one sentence renders the entire prospectus materially misleading because it does not include the phrases “on that day” or “daily basis.” *See* Opp. at 16.

12 Plaintiffs' argument fails as a matter of law. As even Plaintiffs acknowledge (Opp. at 8),
13 a prospectus must be read "as a whole" to determine whether it affirmatively creates a misleading
14 impression. *E.g., In re Infonet Servs. Corp. Secs. Litig.*, 310 F. Supp. 2d 1080, 1092 (C.D. Cal.
15 2003) (*citing In re Stac Elecs.*, 89 F.3d at 1408). Here, the prospectus "as a whole" does not
16 come close to affirmatively suggesting to investors that the Fund is generally suitable as a "long-
17 term investment vehicle".

18 To begin with, the “investor profile” itself says *nothing at all* about the long- or short-term
19 nature of the Fund. It certainly does not “affirmatively create” the impression that the Fund *is*
20 appropriate for “long-term investors” or that it *is* a “long-term investment vehicle.” *See, e.g.,*
21 *Kairalla*, 2008 WL 2879087, at *3.⁸

Moreover, the investor profile cannot be wrenched from its context. That context includes the lengthy surrounding disclosures (*see supra* pp. 3-4) describing (i) the fund's daily investment objective and contrasting it to longer term objectives; (ii) the effects of compounding that might

⁸ Plaintiffs also extract the following sentence from the Fund’s Annual Report: “[A]n investor benefits from the Rydex Inverse Government Long Bond Fund in a rising interest rate environment.” Opp. at 16. Much like the “investor profile” disclosure, this statement simply does not “describe” the Fund as “appropriate” for a “long-term investor,” and certainly does not come close to affirmatively creating that impression when read in context.

1 cause the Fund to deviate from the benchmark over time; (iii) the importance to all fund investors
 2 of understanding compounding; and (iv) the Fund’s historical deviation from the benchmark over
 3 time. Significantly, these are all of the disclosures that actually address the time horizon of the
 4 Fund, and none of them supports Plaintiffs’ assertions.

5 In addition, the very same page that contains the investor profile warns investors that the
 6 Fund is subject to “Active Trading Risk,” which includes the potential consequences of having a
 7 “significant portion” of the Fund’s investors engaging in “frequent trading of Fund shares.” 2007
 8 Prosp. at 16; 2008 Prosp. at 28-29; 2009 Prosp. at 25. Indeed, the prospectuses go even further
 9 and explain that the Fund is “designed and operated to accommodate frequent trading[.]” 2007
 10 Prosp. at 90, Kotler Decl., Ex. A; 2008 Prosp. at 107, Kotler Decl., Ex. B; 2009 Prosp. at 95,
 11 Kotler Decl., Ex. C.

12 Thus, once the prospectuses are properly read as a whole, it is clear that that all Plaintiffs
 13 have done is pull one sentence from the prospectuses out of context, mischaracterize it, and then
 14 assert that additional disclosures are necessary to correct their own mischaracterization. This is
 15 precisely the type of untenable allegation that this Court and the Ninth Circuit routinely reject as
 16 failing to state a viable Section 11 claim. *See Rydex MTD* at 18-19 (collecting cases).

17 **b. As The Fund’s Disclosures Explain, The Fund And Its Fee
 18 Structure Were Designed To Accommodate, Not Punish, Short-
 Term Trading**

19 Plaintiffs fare no better by arguing that the Fund’s fee structure somehow affirmatively
 20 created the impression that the Fund was intended to be a “long-term investment vehicle.” Opp.
 21 at 1. First, this theory was never pleaded in the Complaint. *See Watts v. Enhanced Recovery*
 22 *Corp.*, No. 10-02606, 2010 WL 4117452, at *3 (N.D. Cal. Oct. 19, 2010) (holding that a motion
 23 to dismiss opposition may not rely on facts not pleaded in the complaint). Instead, the Complaint
 24 alleges that the prospectuses’ inclusion of hypothetical examples regarding the fees that an
 25 investor would pay over 1-year, 3-year, 5-year, and 10-year periods misleadingly “impl[ied] that
 26 the Fund was an appropriate vehicle for long-term investing.” FAC ¶41. But as the Rydex MTD
 27 explained, the Fund was required by law to make these disclosures, so as a matter of law they
 28

1 cannot be deemed to be misleading. *See* Rydex MTD at 18.⁹

2 Unable to dispute this legal defense, Plaintiffs' Opposition claims instead that the amount
 3 of the fees themselves--rather than the Fund's discussion of them--somehow violates the
 4 securities laws. *See, e.g.*, Opp. at 18. Even if it had been pleaded, this new allegation would fail
 5 to state a claim because Plaintiffs provide the Court with only a partial--and grossly misleading--
 6 description of the Fund's fees.¹⁰ When the Fund's entire fee structure is considered, it is crystal
 7 clear that the Fund was deliberately structured to facilitate, rather than discourage, short-term
 8 trading.

9 As the prospectuses explain, “[u]nlike most mutual funds,” once investors purchase shares
 10 in one Rydex fund and pay the associated fees,¹¹ they are entitled to transfer their investment into
 11 other Rydex funds--including the Fund--an unlimited number of times *at no cost*:

12 Unlike most mutual funds, the Funds offer ***unlimited exchange
privileges with no minimum holding periods or transaction fees***.

13 An exchange is when you sell shares of one Rydex Fund and use
 14 the proceeds from that sale to purchase shares of another Rydex
 Fund.

15 2007 Prospectus at 86 (emphasis added); 2008 Prosp. at 102 (same); 2009 Prosp. at 92 (same).
 16 Because these exchange privileges require “no minimum holding periods,” a Rydex investor
 17 could, for example, trade in and out of the Fund on a daily basis at no cost by buying Fund shares
 18 one day, transferring his investment into certain other Rydex funds (including a money market
 19 fund) the following day, and then repeating this process on an unlimited number of days. Thus,
 20 Rydex's fee structure--unlike that of most other mutual funds--was designed to accommodate
 21 precisely the type of short-term trading that Plaintiffs wrongly claim is “entirely uneconomical”

23 ⁹ The Fund also was obligated to include the historical return information that Plaintiffs recite in
 24 their Complaint. *See* Rydex MTD at 18. That may be why Plaintiffs essentially have abandoned
 any claim based on the Fund's disclosure of its historical returns.

25 ¹⁰ The Securities Act regulates the Fund's disclosures; it is not a vehicle for complaining that the
 26 Fund's fully-disclosed fees allegedly were too high. *See Benzon*, 420 F.3d at 609 (rejecting an
 attempt to “shoehorn” a claim based on the purported illegality of selling a class of mutual fund
 shares into “a disclosure violations argument”).

27 ¹¹ The Fund is part of the Rydex family of funds. Consistent with industry practice, to
 28 compensate brokers for introducing investors to the Rydex family of funds, investors are charged
 a fee on their initial purchase of shares in one of the Rydex funds.

1 with respect to the Fund. Opp. at 16.¹²

2 Indeed, the prospectuses explain that frequent, short-term trading in and out of the Fund
 3 could adversely impact the Fund's investors. Specifically, under the heading, "FREQUENT
 4 PURCHASES AND REDEMPTIONS OF FUND SHARES," the prospectuses state:

5 *Because the Funds are designed and operated to accommodate
 frequent trading by shareholders and, unlike most mutual funds,
 offer unlimited exchange privileges with no minimum holding
 periods or transaction fees, the Funds' Board of Trustees has not
 adopted policies and procedures designed to prevent market
 timing or to monitor for frequent purchases and redemptions of
 Fund shares.* A significant portion of the assets of the Funds come
 9 from investors who take part in certain strategic and tactical asset
 allocation programs. *The Funds anticipate that investors who take
 10 part in these programs may frequently redeem or exchange shares
 of the Funds*, which may cause the Funds to experience high
 11 portfolio turnover. Higher portfolio turnover may result in the
 12 Funds paying higher levels of transaction costs and generating
 greater tax liabilities for shareholders. In addition, large
 13 movements of assets into and out of the Funds may negatively
 impact a Fund's ability to achieve its investment objective.

14 2007 Prospectus at 90-91 (emphasis added); 2008 Prosp. at 107 (same); 2009 Prosp. at 95 (same).
 15 Plaintiffs nowhere acknowledge the existence of these disclosures.

16 The Fund's fee and frequent-trading disclosures plainly do not come close to
 17 "affirmatively creating the impression" that the Fund is appropriate only for long-term investors
 18 who do not actively manage their portfolios. Instead, they "affirmatively create" precisely the
 19 opposite impression, just like the prospectuses' clear and repeated disclosures about the "daily"
 20 nature of the Fund and the effects of compounding. Accordingly, Plaintiffs' attempt to impose a
 21 duty on the Rydex Defendants to opine about suitability or to state expressly that "the Fund was
 22 suitable only for short-term investors who actively manage their portfolios on a daily basis" fails
 23 as a matter of law.

24 ¹² Plaintiffs also contend that the 1% contingent deferred sales charge that applies to certain sales
 25 of A-Class and C-Class shares "tell[s] investors in the strongest possible terms that they should
 26 expect to hold their shares" for at least a year. Opp. at 4; *see also id.* at 16-17. But Plaintiffs fail
 27 to tell the Court that these charges do not apply to *exchanges*. Thus, the right of Fund investors to
 28 "unlimited exchange privileges with no . . . transaction fees" (2007 Prosp. at 86; 2008 Prosp. at
 102; 2009 Prosp. at 92) also fatally undermines any argument that the Fund's contingent deferred
 sales charges somehow affirmatively create the impression that the Fund is appropriate as a long-
 term investment vehicle.

1 **II. PLAINTIFFS CANNOT BOOTSTRAP A CLAIM THAT THE 2007 AND 2008**
 2 **PROSPECTUSES WERE MISLEADING BY RELYING ON ADDITIONAL**
 3 **DISCLOSURES MADE IN 2009**

4 Having failed to demonstrate that the 2007 and 2008 disclosures were materially
 5 misleading as written, Plaintiffs argue that those disclosures must have been misleading because
 6 the Fund made additional disclosures in 2009. *E.g.*, Opp. at 1. This argument also fails.

7 First, Plaintiffs mischaracterize the 2009 Supplement by claiming “Defendants
 8 acknowledged in a Prospectus supplement that the Fund was *only* appropriate as a short-term
 9 trading vehicle.” Opp. at 1 (emphasis added); *accord id.* at 11, 16-18. Not so. The Supplement
 10 actually states that “[t]he Funds are *generally* intended to be used as short-term trading vehicles.”
 11 Rydex MTD, Korol Decl., Ex. J at 1 (emphasis added). Likewise, the SEC’s Investor Notice
 12 expressly states that “there may be trading and hedging strategies that justify holding these
 13 investments longer than a day[.]” *Id.*, Ex. L at 3. That is why the SEC recommended that “buy-
 14 and-hold investors” *themselves*--presumably in consultation with their brokers--“carefully
 15 consider whether these ETFs are appropriate for their portfolio.” *Id.*

16 Second, Plaintiffs are wrong as a matter of law when they assert that the existence of the
 17 additional 2009 disclosures “is the strongest possible evidence” that earlier Prospectuses were
 18 materially misleading. Opp. at 19. To the contrary, subsequent disclosures cannot even be
 19 considered. Plaintiffs do not cite *any* pertinent authority supporting their hindsight argument, and
 20 there is none.¹³ Rather, “[t]he question is whether the prospectus, as written” was materially
 21 misleading. *Greenapple v. Detroit Edison Co.*, 618 F.2d 198, 211 (2d Cir. 1980). As the
 22 *Greenapple* court further recognized, “[t]o be sure, the quality of the disclosure could have been
 23 improved. But the advisability of revision does not render what was done deceptive or
 24 misleading.” *Id.*; *see also* Rydex MTD at 14.

25 It is for this reason that, consistent with Federal Rule of Evidence 407, courts do not even
 26 consider later disclosures when examining whether earlier disclosures were materially
 27 misleading.

28 ¹³ Plaintiffs cite *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 618 F. Supp. 2d 311, 322 (S.D.N.Y.
 29 2009), but that case does not even address subsequent disclosures, much less say that they are the
 30 “strongest possible evidence” of a prior misleading statement.

1 misleading. *See, e.g., Malone v. Microdyne Corp.*, 26 F.3d 471, 480 (4th Cir. 1994); *Krouner v.*
 2 *Am. Heritage Fund, Inc.*, 899 F. Supp. 142, 147 (S.D.N.Y. 1995) (dismissing Sections 11 and
 3 12(a)(2) claims). Plaintiffs attempt to distinguish these cases by misquoting Rule 407.
 4 According to Plaintiffs, Rule 407 applies only when the subsequent remedial measures are
 5 offered to prove “negligence or culpable conduct.” Opp. at 19 n.6. But what the Rule actually
 6 says is that subsequent remedial measures are inadmissible “to prove negligence, culpable
 7 conduct, a defect in a product, a defect in a product’s design, ***or a need for a warning or***
 8 ***instruction.*** Fed. R. Evid. 407 (emphasis added). Plaintiffs’ attempt to leverage the 2009
 9 disclosures to show that “the prior disclosures were inadequate” (Opp. at 19 n.6) is legally
 10 prohibited by Rule 407 and therefore fails as a matter of law.¹⁴

11 CONCLUSION

12 At all relevant times, the Fund has been remarkably successful in achieving its objective
 13 of matching the Fund’s benchmark, *i.e.*, the inverse of the daily price movement of the Long
 14 Bond, on a daily basis. Plaintiffs’ effort to build a lawsuit on the assertion that Defendants
 15 misleadingly portrayed the Fund as a “simple directional investment” that would match the
 16 inverse of the Long Bond’s price movement not on a daily basis, but rather over “long periods of
 17 time” was doomed from the start and now has largely been abandoned because it is flatly
 18 contradicted by the actual Fund disclosures.

19 That retreat has left Plaintiffs in the position of searching for new theories. But no matter
 20 what positions they advance, in each instance they ignore enormous portions of the Fund
 21 disclosures entirely and selectively quote and mischaracterize others out of context. Equally
 22 troubling, Plaintiffs simply ignore important and dispositive legal arguments and entire bodies of
 23 law cited in the Rydex Defendants’ motion. And when they do address the caselaw, their
 24 descriptions of the cases rarely withstand scrutiny.

25 All of this reflects the fact that Plaintiffs’ case is fatally flawed. The Fund affirmatively
 26 disclosed its daily goal, the risks of deviating from the Fund benchmark over time due to the

27 ¹⁴ Plaintiffs do not contest that their Section 11 claim against Defendant Goldman fails. *See*
 28 Rydex MTD at 22 n.24. Accordingly, this claim must be dismissed.

1 inherent effects of compounding, and the Fund's actual historical deviation from that benchmark.
 2 The Fund also disclosed that it is structured and operated--including its fee structure--to facilitate,
 3 not inhibit, frequent short-term trading. Nothing Plaintiffs can plead will change these facts or
 4 transform them into a viable claim under Sections 11 or 12(a)(2) of the Securities Act.

5 For the foregoing reasons, as well as those set forth in the opening briefs on this motion
 6 and the Independent Trustees' reply brief, and because amendment would be futile, Plaintiffs'
 7 First Amended Class Action Complaint should be dismissed with prejudice.

8 Dated: November 30, 2010

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